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Macroeconomic policy questions: financing of development, including net transfer of resources between developing and developed countries

Towards a stable international financial system, responsive to the challenges of development, especially in the developing countries

Report of the Secretary-General**

Addendum

Regional perspectives and developments

Summary

The Asian financial crisis and its contagion effect generated a new impetus in favour of fundamental reforms in the international financial architecture to improve the management of financial crises, as well as to prevent a recurrence of similar crises in future. The crisis heightened the awareness of and, indeed, led to a recognition that there is an enormous discrepancy between the sophisticated and dynamic financial world and the institutions that regulate it, that "existing institutions are inadequate to deal with financial globalization" (see report of the Task Force of the Executive Committee on Economic and Social Affairs entitled "Towards a new international financial architecture", 21 January 1999). Accordingly, the regional commissions welcomed General Assembly resolution 54/197 of 22 December 1999 which, inter alia, stressed the need to further define the role and improve the capacities of the international, regional and subregional financial institutions with regard to the prevention, management and resolution in a timely and effective manner of international financial crises, and to encourage efforts to enhance the stabilizing role of regional and subregional financial institutions and arrangements in supporting the management of monetary and financial issues, in accordance with the mandate of each institution. The Executive Secretaries of the regional commissions provided their views on this matter to the Economic and Social Council at its substantive session of 2000 (see the report of the Secretary-General on regional cooperation in the economic, social and related fields (E/2000/10 and Add.1-3)). The present addendum provides an updated account of the relevant developments at the regional levels and the views of the Executive Secretaries of the regional commissions there.

* A/55/150 and Corr.1 and 2.

** The present report was submitted after 3 July owing to the extensive consultation process that was undertaken, as requested in para. 21 of resolution 54/197, which took longer than expected.

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1. The fairly rapid though incomplete normalization of capital markets is giving way to a sense of complacency that could slow down the reform effort and prevent the opportunity from being seized to broaden the agenda and set in motion a representative, balanced negotiation process. The Executive Secretaries felt, therefore, that the agenda should be broadened in at least two senses: first, it should go beyond the issues of financial crisis prevention and resolution (which may be termed the "narrow" financial architecture) to include those associated with development finance and the "ownership" of economic and, particularly, development policies; and, second, it should consider, in a systematic fashion, not only the role of world institutions, but also regional arrangements and the areas where national autonomy should be maintained or strengthened.

2. There are at least three arguments in support of a strong role for regional institutions in the new financial order. The first is that globalization also entails open regionalism. The growth of intraregional trade and direct investment flows are, indeed, striking features of the ongoing globalization process. This factor increases macroeconomic linkages and thus the demands for certain services provided by the international financial system: macroeconomic surveillance and internalization of the externalities that national macroeconomic policies have on neighbouring countries, mutual surveillance of each other's mechanisms for the prudential regulation and supervision of the financial system, and regional effects of potential debt standstills and workout procedures.

3. Secondly, some of these services may be subject to diseconomies of scale and it is unclear whether others have sufficiently large economies to justify single international institutions in specific areas. Traditional issues of subsidiarity are thus raised. For example, macroeconomic consultation and surveillance at the world level may be necessary to guarantee policy coherence among major industrialized countries, but it would certainly be inefficient with regard to managing the externalities generated by macroeconomic policies on neighbours in the developing world (or even within Europe). Owing to differences in legal traditions and the sheer scale of the diseconomies involved, surveillance of national systems for the prudential regulation and supervision of financial sectors, and even the definition of specific minimum standards in this area, may be dealt with more appropriately with the support of regional institutions. Development finance can operate effectively at different scales and can perform certain functions at regional and subregional levels that could not be performed at the international level. Also, although regional and international contagion implies that the management of the largest balance-of-payments crises should be assigned to a single world institution, it is unclear how far this assertion should be pushed. Strong regional institutions can serve as regional buffers, as the post-war Western European experience indicates. Regional reserve funds can also play a useful role in the developing world and, if expanded, could even provide full support to the small and medium-sized countries within some regions. Also, as the rising concentration of balance-of-payments support in a few countries indicates, there may be biases in the response of the international community according to the size of the country, a fact that would argue for a division of labour in the provision of services in this area between world and regional organizations.

4. The third argument is that, for smaller countries, the access to a broader menu of alternatives to manage a crisis or to finance development is relatively more important than the "global public goods" that the largest international organizations provide (for example, global macroeconomic stability) and upon which they will assume they have little or no influence (in other words, they have the attitude of "free riders"). Owing to their small size, their negotiating power vis-à-vis large organizations is very limited, and their most important defence is therefore competition in the provision of financial services from such institutions.

5. There may be a fourth, political economy-related argument: countries are likely to take quite different attitudes to the analyses made by international and regional organizations (and in respect of the attached conditionality). They are probably more likely to "own" the latter, inasmuch as they feel they have a stronger voice in the analyses made by regional organizations. This fact will improve rather than reduce effectiveness. The fear that this may lead to lax arrangements is unwarranted, as the proposal to create and strengthen regional financial institutions entails financial commitments by developing countries to provide the capital for the corresponding reserve funds and development banks, and this will lead the countries to closely monitor the soundness of their activities.

Indeed, the supply of capital will be the single most important restriction to the growth of these regional financial networks. The fact that many of these institutions will raise money in the market will provide an additional means of control over their operations.

6. The current discussion has underscored the fact that some services provided by international financial institutions, including some "global public goods", are being undersupplied. However, it would be wrong to conclude from this statement that the increasing supply should come from a few world organizations. Rather, the organizational structure, in some cases, should have the nature of networks of institutions that provide the services required on a complementary basis and, in others, should function as a system of competitive organizations. The provision of the services required for financial crisis prevention and management should be closer to the first model, whereas, in the realm of development finance, competition should be the basic rule (and, in fact, should include competition with private agents as well). However, purity in the model's structure is probably not the best characteristic: it is desirable that parts of networks compete against each other (for example, regional reserve funds versus the International Monetary Fund (IMF) in the provision of emergency financing) and that competitive organizations cooperate in some cases.

7. This implies that IMF of the future should be viewed not as a single, global institution, but rather as the apex of a network of regional and subregional reserve funds. This model should be extended to the provision of macroeconomic consultation and surveillance, as well as to coordination and surveillance of national systems of prudential regulation and supervision complementing, rather than substituting for, regular IMF surveillance. It is important to emphasize that, aside from other functions, subregional development banks can play a significant role as a mechanism for pooling the risks of groups of developing countries, thus allowing them to make a more aggressive use of opportunities provided by private capital markets.

8. An institutional framework such as that suggested would have two positive features. First of all, it may help to bring more stability to the world economy by providing essential services that can hardly be provided by a few international institutions, particularly in the face of a dynamic process of open regionalism. Second, from the point of view of the equilibrium of world relations, it would be more balanced than a system based on a few world organizations. This would increase the commitment of less powerful players to abide by rules that contribute to world and regional stability.

9. There appear to be at least two strategies in which countries, and regional or multilateral institutions can engage in order to avoid or contain the effects of crisis. The first is to engage in surveillance and early warning systems that can detect the possibility of oncoming shocks. The second is to concentrate efforts in making the real and financial economy more robust and less vulnerable to shocks. Closely allied to this are measures to strengthen financial systems and improve risk management. Of course, these two strategies are not mutually exclusive. Rather, in the light of the inherent limitations of surveillance and early warning systems, the second strategy of strengthening the financial system and making the economy more robust against stress should be pursued simultaneously.

10. From the point of view of trade, especially in the regions that suffered from the recent crisis, the growing integration of intraregional trade in East and South-East Asia as well as in Latin America has been an important aspect of the integration of those economies into the global trading system. It was also a contributing factor to the rapid growth of some of those countries prior to the Asian financial crisis, and, subsequently, to their recovery. Nevertheless, since the regional integration of trade, production and financial flows produces both positive and negative consequences on financial stability among those countries, the real issue is not whether regional financial arrangements conflict with the global solutions but, rather, how the benefits of regional integration processes could be reinforced so as to provide greater financial stability and support for high rates of economic growth.

11. Moreover, new and institutional arrangements at the global level without proper recognition of the special situation of the developing and transition economies may have put those countries at a sudden disadvantage. For example, if the Revised Basle Capital Accord was to be put into effect, it would allow for punitive risks weighting in respect of loans to banks in emerging market economies that did not meet the relevant standards. This is not to say that the standards are necessarily undesirable; but the problems of transition and developing economies in creating the

conditions required to be able to comply need to be carefully analysed.

12. The heightened awareness about the regional dimension of financial crisis since the Asian crisis has also generated discussions as well as the articulation of new ideas at intergovernmental levels at various relevant regional and subregional forums, including the regional commissions. The deliberations in those forums increasingly underlined the need to strengthen national policies and technical and analytical capabilities for crisis prevention and crisis resolution. Those discussions affirmed that subregional, regional and global efforts in early warning could be important in ensuring that any situation that had the potential to cause economic and financial instability was clearly signalled. They noted that surveillance and policy coordination at regional level could help reduce the risk of future crises. There are several ongoing initiatives at the regional and subregional levels. Those include the Asia-Pacific Economic Cooperation (APEC), the Framework for Enhanced Asian Regional Cooperation to Promote Financial Stability (Manila Framework), the Asian Recovery Information Centre of the Asian Development Bank and the Association of Southeast Asian Nations (ASEAN) Surveillance Process. The discussions recognized the need to build on those initiatives and to widen coverage to include more countries, in addition to those struck by the recent crisis. The discussions further saw that there was a role for the regional commissions as a source of technical assistance, advice and analyses, and as a forum for the exchange of knowledge and experience on issues of concern, including developments in the debate on the reform of the international financial architecture and participation of the developing countries in that process.[1]

13. During the meeting of the Board of Governors of the Asian Development Bank, held in May 2000, the Ministers of the ASEAN group as well as three other leading countries of that region, namely, China, Japan and the Republic of Korea (ASEAN + 3), held a meeting to exchange views on national economies and financial situations and to discuss further cooperation. They issued a joint Ministerial statement on 6 May 2000 focusing on strengthening policy dialogues and regional cooperation activities in the areas of capital flows monitoring, self-help and support mechanisms and international financial reforms. The ASEAN + 3 Framework is to be used to facilitate the exchange of consistent and timely data and information on capital flows. As a first step towards a monitoring system for the larger East and South-East Asian region, they agreed to establish a network of contact persons to facilitate economic reviews and policy dialogues. They recognized the need to establish a regional financing arrangement to supplement existing international facilities. Thus, the "Chiang Mai Initiative" involves an expanded ASEAN Swap Arrangement including all ASEAN members and the network of bilateral swap and repurchase agreement facilities with the other three partners. They requested the ASEAN secretariat to coordinate a study on other appropriate mechanisms that could enhance their ability to provide sufficient and timely financial support to ensure financial stability in that region. The follow-up work to the Chiang Mai Initiative is under way.

14. As requested by the Preparatory Committee for the High-level International Intergovernmental Event on Financing for Development in pursuance of General Assembly resolution 54/196, the regional commissions, in cooperation with the United Nations Conference on Trade and Development (UNCTAD) and other relevant organizations, are in the process of organizing in the five regions, High-level Consultative Meetings on Financing for Development, to be held between August and December 2000. The topics before these meetings, which focus on regional perspectives, include domestic resources mobilization, external private flows, reform of the international financial architecture together with its regional and subregional support arrangements, innovative sources of financing and the external sector including official development assistance (ODA), and trade. The outcome of these consultative meetings should be of relevant interest for future deliberations on the international financial architecture.

Notes

[1] For instance, please see the record of the discussion at the fifty-sixth session of the Economic and Social Commission for Asia and the Pacific to appear in *Official Records of the Economic and Social Council, 2000, Supplement No. 19* (E/2000/39) (E/ESCAP/1197).

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Towards a stable international financial system, responsive to the challenges of development, especially in the developing countries

Report of the Secretary-General**

Addendum

The Secretary-General has the honour to submit to the General Assembly, as requested in its resolution 54/197 of 22 December 1999, information on work undertaken by the United Nations Conference on Trade and Development on the involvement of the private sector in the prevention and resolution of financial crises.

* A/55/150 and Corr.1 and 2.

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Information on work undertaken by the United Nations Conference on Trade and Development on the involvement of the private sector in the prevention and resolution of financial crises

Note by the UNCTAD secretariat

1. The issue of greater private sector involvement in the prevention and resolution of financial crises and of a more equitable distribution of the cost of adjustments between the public and the private sectors and among debtors, creditors and investors has been a subject of the research activities of the Macroeconomic and Development Policies Branch of the United Nations Conference on Trade and Development (UNCTAD), the results of which are regularly made available in the *Trade and Development Report* and other publications, and of the technical cooperation activities of the Division on Globalization and Development Strategies. A major focus of the work has been the possibility of extending insolvency principles such as those existing in the national bankruptcy codes of industrialized countries to international debt. In the past crisis situations, ad hoc bailout operations by multilateral institutions have typically protected creditors from bearing the full risk of their lending decisions, putting the burden almost entirely on debtors. They have also tended to create moral hazard for private international lenders, encouraging imprudent lending practices. Such operations have become increasingly difficult to justify. The application of insolvency principles would help not only to make the resolution of financial crises in developing countries more equitable, less costly and less time-consuming, but also to reduce the probability of the occurrence of such crises.

2. UNCTAD's work on such an extension of insolvency principles has revealed that an effective framework for greater private sector involvement would need to contain three key elements: (a) provisions for an automatic standstill on debt servicing which would give the debtor the "breathing space" required to formulate a debt reorganization plan; (b) maintaining the debtor's access to the working capital required for the continuation of its operations; and (c) an arrangement for the reorganization of the debtor's assets and liabilities, aimed at sharing the adjustment burden between debtor and creditors as well as at distributing equitably the costs among creditors. The latter arrangement may involve debt rollover, extension of existing loans, and debt write-off or conversion, with the specific combination depending on the particularities of each case. There may also be a need for some institution to act as neutral umpire and facilitator, with the authority when necessary to impose a binding settlement on the competing claims of the creditor and debtor.

3. The issue was first taken up in the *Trade and Development Report 1986*[1] in connection with proposals for a resolution of the sovereign debt crisis in the 1980s. At the time, the lack of a framework governing international debtor-creditor relations comparable with that governing internal debtor-creditor relations in industrialized countries was perceived to be a hindrance to a rapid solution of the external debt problems of developing countries. *Trade and Development Report 1986* thus recommended the extension and application of national insolvency principles to international debt, arguing that, in situations of international debt crisis, debtors are "judged de facto bankrupt, with all the consequences that this entails as regards creditworthiness and future access to credits. At the same time, they are largely without the benefits of receiving the financial relief and financial reorganization that would accompany a de jure bankruptcy handled in a manner similar to chapter 11 of the United States Bankruptcy Code".[2]

4. While in the 1980s the main problem had been the external debt owed by Governments to commercial banks, either directly or indirectly through guarantees extended to private borrowers, in the mid-1990s the external financial obligations of developing countries became increasingly private in character. Thus, the applicability of insolvency principles to protect debtors and to assure equal treatment of creditors has gained even more relevance, and the subject was taken up again in the *Trade and Development Report 1998*,[3] for consideration by the Trade and Development Board at its forty-fifth session.[4] It was stated in the *Trade and Development Report 1998* that "bankruptcy procedures are especially relevant to international debt crises resulting from liquidity problems because they are designed to address financial restructuring rather than liquidation".[5] The *Trade and Development Report 1998*

also reiterated that, in the absence of timely provision of adequate liquidity to counter attacks on a currency, the most effective way to prevent widespread defaults and bankruptcies would be through extension and application of insolvency procedures that allowed for a standstill on debt servicing.[6] It was recognized that article VIII (2 (b)) of the International Monetary Fund (IMF) Articles of Agreement might provide a statutory basis for the application of debt standstills as a central element of international insolvency procedures, through the imposition of exchange controls when a currency came under attack. A temporary introduction of such controls could be combined with existing practices for restructuring debt through negotiations. Under certain conditions, such a standstill could be decided unilaterally by a debtor country facing an attack on its currency, and then be submitted to a standstill authority. Such a procedure would be similar to World Trade Organization/General Agreement on Tariffs and Trade (GATT) safeguard provisions for emergency trade measures. It was also considered that, in order to avoid a conflict of interest on the part of IMF, which in many cases is itself a creditor to countries affected by a currency attack, it might be desirable to entrust standstill authority to an independent panel.

5. Various facets of the issue were pursued further in 1999 in an UNCTAD Discussion Paper, prepared by staff of the Macroeconomic and Development Policies Branch.[7] It was emphasized that, in order to prevent problems associated with a generalized withdrawal of capital and currency depreciation, debt standstills would need to be accompanied by temporary exchange controls over all capital-account transactions (by residents as well as non-residents) and by IMF "lending into arrears". On the other hand, such an approach would require much less funding than the bailout operations undertaken by IMF in recent financial crises, and the Fund could also help arrange emergency lending from private capital markets.

6. In a more recent UNCTAD Discussion Paper,[8] assessing the progress in various areas of reform of the international financial architecture, it was noted that no agreement had been reached as yet over the role of IMF in standstill arrangements and over the desirability of establishing an international rules-based system for crisis solution. Owing to this lack of agreement, greater emphasis was placed in the international debate on voluntary mechanisms, but mechanisms such as comprehensive bond covenants, automatic rollover options and collective action clauses designed to enable debtors to suspend payments were unlikely to be introduced voluntarily. Moreover, if such clauses were not to reduce developing countries' access to financial markets, they would probably first need to be introduced for the sovereign bonds of industrialized countries, and this was an objective that, in turn, might require international agreement.

7. The subject was also in the agenda of a meeting on the Future of the International Monetary and Financial System, organized by the UNCTAD secretariat in Geneva on 25 and 26 January 1999 and attended by 30 high-level experts, including members of Government, leading economists of IMF, the World Bank and the Bank for International Settlements and renowned international academics. The meeting was convened in connection with the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-four on International Monetary Affairs (G-24), with the aim of providing guidance to developing countries in their preparation for negotiations on the reform of the international monetary and financial system. The experts recognized that, in the area of international money and finance, Governments and central banks, even of the major industrialized countries, had been losing influence to private actors and the financial markets, and that there could be a conflict between the public interest of financial stability for long-term growth and development and the private financial sectors' focus on quick profits. As a consequence, some of them perceived a need for financial regulation in order to circumscribe the freedom of behaviour of private agents and for rules to assure that creditors took a major responsibility in solving international liquidity crises. One element of special importance in this context was the establishment of specific rules on "systemic bankruptcy" by which a large number of debtors are affected simultaneously, even though their businesses are fundamentally sound. Systemic bankruptcy has major macroeconomic consequences and should be distinguished from cases of individual bankruptcy that may arise from mismanagement of a firm but do not have such consequences.[9]

8. The facilitation of orderly workouts for cross-border private debt was also the subject of a special research project, also in connection with UNCTAD's support of the G-24. The results of this project were

discussed by the Technical Group of the G-24 at its meeting in Colombo, Sri Lanka, in March 1999, and subsequently by the meeting of G-24 Deputies and Ministers in Washington, D.C., in April 1999.[10] The research showed that the more open and less regulated financial markets are, the more they are prone to panic, because financial flows can move much more quickly and in larger volumes than goods and services, and also because financial markets operate in an environment of imperfect information. When perceptions suddenly shift, it may be rational for *individual* creditors to abruptly demand full repayment from borrowers, even though such actions make creditors *collectively* worse off as a result. It was underlined that not only public institutions including lender of last resort and financial supervisory and regulatory bodies, but also institutions and rules that assured private sector involvement, such as deposit insurance systems, and clearly defined and transparent systems for managing bankruptcies, liquidations and other forms of debt workouts, were important preconditions for the stability of any financial system. Attention was also drawn to the fact that the key principles for orderly debt workout are to be found not only in national bankruptcy procedures but also, albeit in less formalized fashion, in the workout mechanisms for cross-border sovereign debt as practised in the framework of the Paris Club and the London Club. The introduction of collective action clauses in international bond contracts was suggested as an important step towards containing international financial panic, since these would help to coordinate creditor action on standstills and debt rollovers. With respect to new financing, while IMF should explore new facilities through which certain countries can prequalify for fast-disbursing, low-conditionality loans, the private sector should also play a much larger role in providing fresh funds to countries in distress. Such new private financing should, however, be voluntary and be given senior status. It was underlined that an effective payments standstill mechanism would itself contribute to creating the stable environment needed to encourage new private sector financing.

9. The question of a more equal distribution of the costs resulting from financial crisis was discussed, from a legal point of view, at the Second Inter-Regional Debt Management Conference on "Challenges and Solutions at the Dawn of the New Millennium", held in Geneva, 3-5 April 2000,[11] in connection with the technical cooperation activities provided through UNCTAD's Debt Management and Financial Analysis System (DMFAS). It was underlined that investors in emerging market debt instruments in particular, who are rewarded by considerably higher interest rates for taking higher risk, should not be shielded from the financial consequences when those risks materialize. A reform of the international financial architecture should aim, first, at smoothing private financial flows to emerging markets in order to avoid the boom/bust pattern of the past and, second, at facilitating prompt, orderly, non-contagious workouts in crisis situations, with attendant losses falling on those who made the investment decisions. One problem that received particular attention from a legal point of view was the need for introducing clauses in the standard form of bond documentation that allowed for greater flexibility in the restructuring of debt in the form of publicly traded bonds. Moreover, there was a discussion on lessons to be drawn from recent cases involving Pakistan, Ecuador and Ukraine regarding the terms of bond restructurings.

Notes

[1] United Nations publication, Sales No.E.86.II.D.5.

[2] Ibid., annex to chap. VI ("Toward international debt reform?").

[3] United Nations publication, Sales No. E.98.II.D.6.

[4] The discussions at the Trade and Development Board were also reflected in the agreed conclusions 451 (XLV) of the Board (see *Official Records of the General Assembly, Fifty-third Session, Supplement No. 15* (A/53/15/Rev.1), part four, chap. I, sect. C), where it was stated, inter alia, that "it may also be useful to explore alternative means of crisis management that would provide safeguards against speculative attacks and disruption of markets, prevent moral hazard, and secure more equitable burden-sharing between debtors and creditors. The establishment of orderly debt workout principles could be further examined" (para. 11).

[5] *Trade and Development Report 1998* ..., part one, chap. IV, sect. B.5 (a).

[6] For a more detailed account of the procedure, see *Trade and Development Report 1998* ..., part one, chap. IV, sect. B.

[7] Y. Akyüz and A. Cornford, "Capital flows to developing countries and the reform of the international financial system", *UNCTAD Discussion Paper, No. 143* (UNCTAD/OSG/DP/143) (Geneva, November 1999).

[8] Y. Akyüz, "The debate on the international financial architecture: reforming the reformers", *UNCTAD*

Discussion Paper, No. 148 (UNCTAD/OSG/DP/148) (Geneva, April 2000).

[9] Deliberations of the G-24 Meeting on the Future of the International Monetary and Financial System, 25-26 January 1999, summary by the UNCTAD secretariat (Geneva, January 1999), mimeograph.

[10] See S. Radelet, "Orderly workouts for cross-border private debt", in *International Monetary and Financial Issues for the 1990s*, vol. XI (UNCTAD/GDS/MDPB/6) (United Nations publication, Sales No. E.99.II.D.25), pp. 61-81.

[11] *Proceedings of the Second Inter-Regional Debt Management Conference*, Geneva, 3-5 April 2000 (UNCTAD/GDS/DMFAS/__), forthcoming.